The Fed and the Economy: Where We're Going, Where We've Been

La Salle University
The 22nd Annual Economic Outlook
Philadelphia, PA

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Good afternoon! It's great to return to this event. It was 2017 when I last spoke at this annual economic outlook. My topic back then focused on challenges in the economy. Here we are in 2023 — and there are still economic challenges to address — albeit very different ones from six years ago.

There are a few areas we'll explore today. First, because I can't resist donning my old teaching cap, I'd like to offer some background about what the Fed is and what it does. I'll also talk about what the Fed *doesn't* do, because sometimes the Fed's powers are overestimated. I'll then pivot to the economic outlook for our country and our region, and touch on my approach to monetary policy. After that, we can get to some questions, which is something I always enjoy and look forward to.

But before we do any of that, I need to give you my standard Fed disclaimer: The views I express today are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Let's start with some Fed history.

Federal Reserve History and Structure

The First Bank of the United States was the brainchild of the man who in recent years has become everybody's favorite founding father: Alexander Hamilton. The bank was located right here in Philadelphia when it was still the capital of the country. It was established in 1791 to deal with the debt from the Revolutionary War and to ensure the government's financial stability. It looked a lot different than the entity we are today, and it wasn't without controversy.

As Broadway has reminded us, Thomas Jefferson was among those who worried about power that was too strong and too centralized. He even once famously said he found banks to be more dangerous than standing armies. When the bank's charter was up for renewal after its initial 20 years, the Jeffersonian argument won out and the measure failed by a vote each in the House and the Senate. The bank was dissolved.

Five years later, Congress agreed to a central banking function a second time, and we launched the imaginatively named Second Bank of the United States. And about 20 years after that, Congress decided not to renew the charter, again owing to a strain of popular sentiment that didn't trust powerful, centralized institutions.

But not having a central bank didn't really work because it tended to breed volatility.

The period leading up to the third iteration of American central banking — the Federal Reserve — was marked by currency instability, bank runs, and cycles of boom and bust. At one point, J.P. Morgan actually had to step in personally to bail out the country. If you've ever been to the Morgan Library & Museum in New York, you can stand in the room where the solution to that financial crisis was worked out.

Even during the Revolutionary War era, central banking was standard in democracies, and it remains that way today. There are no developed economies that don't have it in some form. So, the eventual adoption of our current central bank — in the 1913 Federal Reserve Act — was to some extent inevitable. And the configuration of the Federal Reserve System — a central bank with a decentralized structure — is something of a testament to old-fashioned American compromise. It also reflects the unique demands of the United States and our economy.

The Federal Reserve System consists of a Board of Governors, which sits in Washington, and 12 regional Banks located around the country, including the one I oversee here in Philadelphia.

The Board seats seven governors, including the Chair. Each regional Bank has its own president and board of directors, which is made up of business, banking, and community leaders from the area. Fundamentally, this provides the Fed with a perspective, within each District, of the sectors and issues that make the region tick. We are here in the Third District, which encompasses eastern Pennsylvania, South Jersey, and the state of Delaware. We're the smallest District, geographically, but I like to think we punch above our weight.

The Fed's decentralized nature is, in my view, a unique strength. We're making national policy, but we're doing it for an enormous country, and the averages of economic data can obscure realities on the ground. Conditions can look very different in Philadelphia, Dover, or Trenton than they do in Dallas, Salt Lake City, or Honolulu. This system gives, in my view, a voice to a range of localities and sectors. It also allows us to focus on regional issues within each Bank's District.

The United States has a unique set of needs. It's easy to forget that we're an outlier because we're such a big country: Only Russia and Canada are bigger geographically, only China and India have larger populations, and no other country has a bigger economy, at least for now. And that economy is vast, spreading across sectors and natural resources in a way that most other nations don't.

So, it makes sense that we have a system that feeds back information from around the country.

The other difference from most central banks is that the Fed has a dual mandate rather than a single goal; that is, we're charged with both maximum employment and price stability. Most just focus on one.

Maximum employment encompasses a wide range of metrics, although most attention is paid to the unemployment rate. That number, of course, will never be zero. Instead, we try to ensure that labor markets are functioning dynamically and efficiently. *Price stability*, on the other hand, is low and stable inflation, which we judge to be around 2 percent a year. More on both topics in a bit.

The decisions we make within the Fed — the way we look at the economy and respond to data — are built entirely on the foundation of our dual mandate. It is our North Star.

Now that we've established that, I turn to the question so many people secretly want to ask: What, exactly, does the Fed do? I'm delighted to talk about it, but just as important, I'll also mention what we *don't* do.

We have lending power. What that means is we do *not* have spending power. We have no authority over fiscal policy, which deals with debts, deficits, and taxes. Or investments to encourage growth. Or grants to worthy organizations. Or programs to spur job creation. Those all depend on elected officials, be they on the local, state, or national level.

So, what *do* we do?

We set monetary policy. We also regulate banks, along with an alphabet soup of government agencies. We are the lender of last resort during bona fide emergencies.

And the lede that always gets buried — and I wish it weren't so overshadowed by discussions of interest rates — is that we work within our Districts to help strengthen local communities' economies. We have a truly exceptional team in Philadelphia in our Community Development and Regional Outreach Department, and they work with partners all over the Third District. They're doing truly vital work on employment, transportation, housing, and other issues.

But first, let me talk a bit about monetary policy. Monetary policy is a fairly limited field with a fairly conscripted set of tools.

Our job is to create the conditions in which a healthy economy can thrive. More than anything, we're tilling the land.

Monetary policy is about meeting our dual mandate mostly by moving interest rates. There are other tools we use, but in normal times, it's mostly about moving what is technically called the *federal funds rate*. In the media, that's usually just called the interest rate.

The federal funds rate is the interest rate on loans that banks make to each other overnight. That rate tends to influence interest rates more broadly, so the effect ripples through the economy. When we move the federal funds rate, it affects the interest rate people pay on their mortgages and car loans and that businesses pay to borrow to meet or expand their payrolls or buy inventory. In fact, sometimes just announcing we are planning to raise the federal funds rate in the future affects these lending rates.

We set rates when the FOMC meets in Washington, which we do eight times a year.

Regional Bank presidents don't always get to vote. Most of us rotate into a voting position every three years, but the governors always do, as does the president of the New York Fed. New York, which conducts the Fed's market operations, enjoys something of a "first among equals" status within the

System. I'm voting this year. I've noticed people care a lot more about what I have to say recently, which I'm sure is just a coincidence. Regardless of whether we are voting or not, we do always represent our Districts and play a part in the discussion.

The FOMC discussion is *never* political. Because we're appointed policymakers, we don't respond to swings in public opinion or election cycles. Unlike elected officials, who suffer the slings and arrows of the 24-hour news machine, we operate in a rare, apolitical bubble. I truly believe that the independence of the Fed is crucial to making the best decisions possible for the American economy, free from the pressures of politics.

Although we're independent, that doesn't mean we're unchecked. The Fed is what's considered "independent within the government." We're overseen by Congress, but neither Congress nor the presidential administration has a say in the decisions we make.

That's not to suggest the Fed doesn't come under intense political scrutiny at times, particularly when economic conditions are troubled.

The State of the Economy

I just stepped back in time a few hundred years to consider the Fed's origins. In keeping with that time travel, I think it's worth taking a step back and considering, briefly, how much has transpired over the past several years. You really can't understand where our economy is, or where it's going, without considering where we've come from.

First and foremost, of course, is the humanitarian tragedy that our country — and our world — has endured because of the COVID-19 virus over the past three years. More than 6.5 million people globally have perished from the virus, including more than 1 million of our fellow Americans and nearly 50,000 Pennsylvanians. This is a public health catastrophe on a global scale that is unprecedented in any of our lifetimes.

The tribulations of the U.S. economy over this period have been startling as well. During the early part of the pandemic, the national economy suffered its largest contraction in recorded history as the virus spread and state and local governments closed businesses that they deemed nonessential. Tens of millions of Americans lost their jobs in one of the sharpest recessions in American history.

That downturn was followed by a period of extraordinary economic growth as states loosened restrictions and, with astonishing rapidity, highly effective vaccines against COVID-19 were developed and deployed.

But even as the economy came roaring back to health, scars were visible. Many older Americans had opted to retire at the onset of the pandemic, leaving labor force participation below where it was before COVID-19 arrived on our shores. Supply chains were badly damaged by the virus itself as workers fell ill, and by government lockdowns, which shuttered factories for extended periods. This left crucial and disparate items like computer chips and cream cheese in short supply. Meanwhile, large doses of fiscal spending from the federal government and accommodative monetary policy from the Federal Reserve stoked demand. This led to a phenomenon known colloquially as “too much money chasing too few goods” and the highest inflation in four decades.

Where We Are Nationally

High inflation is a scourge, leading to economic inefficiencies and hurting Americans of limited means disproportionately. I find it particularly disturbing that life’s true essentials like groceries, fuel, and shelter have skyrocketed in price.

The Federal Reserve is absolutely committed to bringing inflation back to our 2 percent target.

And we’re doing that by adjusting our monetary policy. Since March last year, we raised the target range for the federal funds rate from zero to between 4.5 percent and 4.75 percent. That is a significant move, and a very fast one, with the FOMC raising rates 75 basis points at several meetings. But rates are now at a level that allow us to slow down and proceed cautiously and, to my mind, the days of us raising 75 basis points at a time have surely passed. Just at the last meeting, I voted for a hike of 25 basis points — what some would call slow but actually is closer to cruising speed when it comes to tightening. In my view, we are not done yet … but we are likely close.

At some point this year, I expect that the policy rate will be restrictive enough that we will hold rates in place and let monetary policy do its work. We are also shrinking our balance sheet, which is removing a significant amount of accommodation in and of itself.

Our goal is to slow the economy modestly and to bring demand more in line with supply. The Federal Reserve obviously can't fix problems like supply chain issues, though it does seem like these problems are finally easing a bit. Or an endemic shortage of workers, that unfortunately has yet to ease. But we can affect demand by making it more expensive to borrow money. And that's clearly already happening: We're seeing unmistakable signs of a slowdown in the most interest-rate sensitive parts of the economy, like housing.

What's encouraging is that even as we are raising rates, and seeing some signs that inflation is cooling, the national economy remains relatively healthy overall. In parts of 2022, the economy grew modestly even as we were tightening monetary policy substantially. Although inflation is biting, many Americans are still spending — even if they dip into their savings to do so.

We're seeing a healthy recovery in those sectors that suffered the most during the pandemic, like leisure and hospitality, while some sectors that built up healthy order books like manufacturing are cooling. I do remain concerned about commercial real estate, as the embrace of remote and hybrid work is clearly dampening demand for office space in central business districts and suburban office parks.

I'm most pleased that the labor market remains in excellent shape. Last year, the U.S. economy created 4.8 million jobs, and while we are seeing some layoffs in certain segments like tech, there is little evidence of a major downturn in the job market. In fact, in the latest data release, a staggering half a million new jobs were created in January. There is now a record number of Americans employed. And indeed, the national unemployment rate is exceptionally low at 3.4 percent.

Where We Are Locally

In the Philadelphia area, conditions look broadly similar. Much like the national economy, this region's economy reflects weakening conditions in business and interest-rate sensitive areas such as housing, but maintains significant strengths, particularly in the labor market. Payroll growth continues to chug along, and the unemployment rate has fallen and remains low. In fact, in the Philadelphia metropolitan statistical area, the unemployment rate stands at 3.8 percent — effectively, full employment. As of the fourth quarter of 2022, the index for wages and salaries was up above 4 percent year over year in the Philadelphia–Reading–Camden region.

Of course, even in a hot job market, some positions remain more in demand than others. According to an analysis of job listings for the Philadelphia area, some of the most frequent job ads are for registered nurses, retail salespeople, software developers, and customer service representatives, reflecting continued hot demand in health care, tech, and retail.

Now, our region's strengths are vulnerable to ongoing challenges. One obvious weak spot is manufacturing. Responses to the Philadelphia Fed's most recent *Manufacturing Business Outlook Survey*, which covers the area, suggested overall declines in the sector in January. The survey's indicators for current general activity and new orders remained negative, and the survey's future indicators suggest tempered expectations for growth over the next six months.

Housing is also weakening considerably, certainly in part due to higher interest rates. Single-family price growth in Philadelphia County is trending downward and was only around 3.6 percent year over year in November 2022, well down from the 6 percent to 8 percent price growth we experienced during the pandemic. According to Zillow, the share of listings with a price cut has increased over the past year and was 22.7 percent in the Philadelphia metro area as of December. Also in December, the median days on the market for a house for sale in Philadelphia was 41 days, matching the typical pre-pandemic figure, and showcasing a softening in conditions. The days of houses selling before they are even listed are in our rearview mirror.

Where We Are Going

In happier news, we are finally starting to see steady progress bringing inflation down across an array of goods. With monetary policy doing its work, supply chains healing, and excess demand running off, I forecast core inflation to come in at around 3.5 percent this year — well over our 2 percent target, but suggestive of clear movement in the right direction. Core inflation should fall to 2.5 percent in 2024 and then back down to 2 percent in 2025.

GDP growth will be modest, but I'm not forecasting a recession. The labor markets are simply too hot to indicate a significant downturn at this point. I expect real GDP growth of about 1 percent this year before climbing back up to trend growth of about 2 percent in 2024 and 2025.

Lastly, I do think we will see a very slight uptick in unemployment, probably topping out modestly above 4 percent this year. It's an underrated advantage that the Federal Reserve is taking on inflation from a position of such labor market strength.

Conclusion

In sum, the Federal Reserve is committed to bringing down inflation and to maintaining the conditions for a healthy labor market. I hope that the first part of my talk was interesting background and that the second part helped to illuminate today's economic environment.

And one last historical mention — consider a visit to the First and Second Banks of the U.S. — they're right here in our backyard at Independence National Historical Park.

So again, thanks so much for having me. Now let's get to your questions.